AN EU-Inspired Corporate Governance Statement for Maltese Listed Companies – Boon or Scourge ?

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Introduction

The traditional definition of corporate governance is that of *"the system by which companies are directed and controlled"* (Cadbury Committee,1992: p 15). Indeed, corporate governance is concerned with the interaction of a company's management, board of directors and stakeholders in ensuring the fairness of such a system. It needs hardly be said that corporate governance systems needed reform in the past decades for the sake of protecting the various stakeholders. For example, neither the USA nor the European Union could envy each other in the light of recent major corporate scandals such as Enron and Parmalat. Crises stimulate the search for new and more rigorous methods of surveillance and control (Moran, 1986). As would therefore be expected, both legislators and regulatory bodies have been increasingly involved in the tightening up of the global legislative regulatory framework.

Perhaps the strongest evidence of this was, in the U.S.A, the Sarbanes-Oxley Act of 2002 which, according to the Act itself was enacted *"to protect investors by improving the accuracy and reliability of corporate disclosures".* In a comparable manner, in the European Union, the 8^{th} Directive on Company Law was finally implemented in 2006 further to the Commission's 2003 Action Plan for Modernising Company Law and Corporate Governance at EU Level (European Union Commission,2003). Among other changes, the 8^{th} Directive mandates audit committees for listed companies and includes fundamental changes around the relations of the board directors with the auditors.

Indeed, several other new rules, accounting and auditing standards and improvements have by now taken hold in many countries: it is good news for investors that boards of directors are becoming increasingly independent, audit committees are acting with newly found scepticism and autonomy and chief executive officers are assuming greater responsibility for financial reporting (Deloitte and Touche, 2006). After all, a much-quoted survey of investor perceptions indicates that investors are willing to pay more for a company that is well-governed and that the quality of corporate governance standards ranks alongside financial performance and other factors when deciding whether to invest in a company. (Mckinsey,2004).

In this vein, and even beyond legislation, most countries have developed their code of recommendations in this area - witness, for example, the many recent corporate governance codes listed by the European Corporate Governance Institute on its website (ECGI, 2006 online), including that of Malta introduced in 2001, revised in 2005 and intended to be adopted by issuers of listed securities.

Since 2001 the Malta Financial Services Authority (MFSA) listing rules have encouraged such issuers to *'endeavour to adopt'* the principles of the *"Code of Good Corporate Governance"*. The Rules require issuers to include in the Annual Report a statement, verified by the auditors, with regards to the effective measures they have taken to ensure compliance with the Code. Therefore , although the whole Code as such is not obligatory, listed companies in effect would already best adopt the *"comply-or-explain"* principle of explaining from which parts of the code they depart, if they do so, and their reasons.

Yet a largely ignored but important doubt lingers with the advent of the myriad of this and further corporate governance laws, rules, standards and codes: are the overall implications of such a regime, if any, being appropriately weighed? This paper debates some such implications and their significance on Maltese listed companies by considering one particular proposed corporate governance change by the European Union Commission: the statutory inclusion in its Proposed Amending Directive Com (2004) 725 of a Corporate Governance Statement in the annual report of listed companies.

The Proposed New Corporate Governance Statement

The Amending Directive proposes a Corporate Governance Statement which not only requires the application of the *'comply-or-explain'* principle already referred to above to a specified code of corporate governance, but also a number of other disclosure requirements. The main such requirements are:

- the disclosure of the operation of the shareholder meeting and its key powers,

- a description of shareholder's rights and how they can be exercised; as well as the composition and operation of the board of directors and its committees, and

- the disclosure of the companies' internal control and risk management systems.

With regard to the first two disclosures requirements above regarding shareholders and board of directors, these should still create no significant changes with respect Maltese listed companies : the descriptions will mostly involve disclosing what is already required in Maltese company law, in itself EU compliant However, there are major issues to consider even in Malta if the Commission were to move ahead with the third disclosure requirement of the companies' internal control and risk management systems. In this respect, even according to the Explanatory Memorandum of the proposed directive itself (Section 2c), consultation has already shown that stakeholders disagree as to the need to go further than the application of the *"comply-or-explain"* principle. In fact, *"while business was reluctant to go further other stakeholders favoured additional disclosure, in* *particular information about the risk management system applied by listed companies".*

Disclosing to Everybody in the Dark?

A main issue here is that unless benchmarks are first agreed and established as to what is expected to be disclosed, such disclosures will probably be meaningless and mostly wasteful of resources as little, if any, inter-company comparisons or even inter-period comparisons may be carried out. Both phrases "*internal control*" and "*risk management systems*" are wide-ranging and umbrella ones. Internal controls involve so many aspects of the organisation – among others, its plans, lines of reporting, delegation of authority, segregation of duties, physical security aspects, management and supervision, the internal audit, personnel policies, the overall control environment. Similarly, risk management systems also permeate almost everywhere: there are business, financial, physical, managerial, legal, foreign exchange and several other types of risks to manage.

If serious enough, sub-committees of listed company boards of directors such as audit and risk management ones need in fact to be continuously occupied with both controls and risks. Yet, one may ask what with this increased requirement the "*other stakeholders*" are really after, because the exercise may unwittingly result in another public relations showcase showing the acceptable law-abiding face of their companies. How worthwhile is it for such boards to engage further financial and legal consultants at considerable cost to venture out politically correct information? While annual reports are increasingly thick and glossy, they are also probably being read less. Additionally, given the differing tastes of the various stakeholders, there will invariably be variances as to which items to disclose and also as to the desired level of detail – too commonly virtually impossible to satisfy. Can this merely lead to expensive information overload?

Even from the management's perspective, this may be an example of a questionable add-on to the contrasting demands which are continuously being made on them both for more accountability and for more value by stakeholders in search of an ever-bigger piece of the corporate cake. After all, over the years, in addition to much more demanding boards of directors, traditional watchdogs have been highly empowered while others freshly installed, all in the name of corporate governance: the external auditors with their tightened international auditing standards, the internal auditors with their more strategic role, the varying regulators with their pressing and expensive demands, in many instances even three or more of them such as industry, listing and company ones, government authorities at the various levels - local central and European all armed with new compulsory legislation. In allocating scarce resources in a tough, cost-cutting and dynamic environment, the "*boss*" or chief executive officer already finds it difficult as it is to strike a successful balance between delivering a good bottom line and coping with these elements of the regulatory framework.

In particular, stakeholders remote from the boardroom may too easily underestimate the significance of this. Requiring companies to disclose more and more on what they are doing will not necessarily make their operations more understandable. If one is not careful enough, companies may substantially be made to churn much more paperwork than before, but stakeholders given only a false sense of security.

This is not to say that the march of modern corporate governance needs to stop. The scrutiny of the governance and control being exercised at the top is a process that is to go on: new and better ways may be thus found for exercising reasonable checks and balances such as preventing anyone from having unfettered powers of discretion, distinguishing between possibly conflicting roles even beyond chairman and chief executive, and improving on the existing relationships of Boards of Directors and the different types and sizes of shareholders, and even making directors and chief executives more generally accountable. But before promulgating new rules, the regulating authorities need to undertake serious impact assessments of such regulations taking into reasonable account the major stakeholders involved. A lesson to Europe in this context was the largely unforeseen cost to many American companies of implementing the above-mentioned Sarbanes-Oxley Act in the USA. While benefits were clearly reaped, the stricter regime has also resulted in consultancy and audit shooting up dramatically, at least in the initial years. As a result, controversies still rage as to how far it is cost-beneficial both to the companies and their stakeholders.

More specifically to this corporate governance statement requirement, the demand for more information to be made public can have its benefits if the sender knows clearly what to give and the receiver what to expect. This would entail spelling out specific details of the benchmarking standards. In working out these, the regulators would need also to consider and as far as possible take into account the potential pitfalls emanating from the attitudes of the parties involved as such attitudes may effectively inhibit the transmission of meaningful information. For example, senders may be too intent in protecting their interests and may be shrewd or resourceful enough to be able to filter the information in that interest. On the other hand, the major *"stakeholders"* could easily include inquisitive and potentially manipulative competitors, lethargic shareholders interested only in their dividend cheques, potential short-termist investors trying to speculate on the market, financial advisors with too many hats or conflicts of interest (particularly in a small island-state) and even some journalists with their political agenda on how to interpret company communications. While definitely one d cannot solve all issues resulting from such attitudes, yet their consideration would definitely influence the type of information to be asked for.

Giving less but what is needed

Perhaps an even better alternative is to re-examine the need for the corporate governance statement to go beyond the *"comply-or-explain"* principle. If one borrows the concept from auditing, the typical established statutory audit report addressed to company shareholders does not in any way venture information unless there is the need for qualification or emphasis – and the approach seems to have worked. One reason for this is that the accompanying statutory financial statements are already heavily and increasingly regulated as to what to contain or not. One may therefore either decide not to ask for more disclosure with respect to corporate governance, or if more information is to be required, reserve it to the major changes that have occurred in controls or risks during the year. However, this information could also be incorporated with the other statements or reports in the annual report, such as in the directors' report. In any case, one perhaps needs best to avoid general descriptions of systems: what if you were made to listen to the whole story of what happens in your car controls by your mechanic every morning before starting off? In reality, you are only interested if anything is wrong.

Furthermore, inasmuch as a car mechanic will best point out car trouble, it is not the company but an independent specialist who will probably be best equipped to make – rather than merely verify aspects - of the statement. Rather than a financial auditor, perhaps it would be best to engage either a management specialist for the purpose. Thus, if independent Board of Director sub-committees are functioning in a company, the chairman of, say, the Risk Management Committee may be required present the risk management aspect in a report to the AGM, while the chairman of the Audit Committee will present the internal control aspects.

A Question of Priorities

Perhaps, the pertinent question is even more fundamental: is the current emphasis on information disclosure the best approach to ensure progress in corporate governance? Could it be that regulatory priorities need re-shuffling? After all, irrespective of the regulatory framework in force, it is invariably dependent for its success or failure on the persons involved. Before regulating on the information, it could be much better to think of tightening up the present regulation of the persons involved in the process. For this, one perhaps needs to re-visit the corporate governance *modus operandi* taken for granted over the years. For instance, with respect to the minimum qualifications required of directors: should candidates for board directorships in non-financial listed companies continue to be considered fit and proper for the position despite their having no background in ethics, law and finance, and/or business education in general? Are shareholding interests and financial backing to remain enough in practice to secure appointment to the boards of such companies? Furthermore, on being appointed to this position, should a short introductory familiarisation course, if held at all, suffice?

In addition, with respect to the statutory term of appointment of directors: given that they are in charge of long-term strategies for their companies, is it wise to appoint them every annual general meeting? Why not has their appointment for a non-renewable but reasonable number of years such as five to seven years? In this manner one would promote the long-term vision and continuity at the top which are necessary for many corporate governance matters. Why should directors care about minimising risks if the weight of such risks will become apparent only beyond the term of office - next year or even after? Moreover, although a profit retention policy may be needed for a company's long-term financial survival, how can directors refrain from recommending that extra dividend demanded by shareholders once they are completely dependent for imminent re-election?

Conclusion

In conclusion, the proposed corporate governance statement disclosure requirement cannot be described as a scourge, but it is not a boon either. It could easily be like driving a car repeatedly around a roundabout – a fuel-consuming exercise without going any

where. To continue on the car analogy, it is also useless to try to stop cars from overspeeding, but then fail to insist on a proper driver's licence. In the area of corporate governance, we may need not only to slow down and not over-regulate, but, probably even more importantly, to insist with a sense of urgency on a proper licence for the corporate drivers in charge.

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